

This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 02 ISTANBUL 000465

SIPDIS

SENSITIVE

STATE FOR E, EUR AND EB
TREASURY FOR U/S TAYLOR AND OASIA - MILLS
NSC FOR QUANRUD AND BRYZA

E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [PREL](#) [TU](#)

SUBJECT: ISTANBUL ECONOMIC PESSIMISM: "MUDDLING THROUGH" AS
THE UPSIDE

REF: ANKARA 2151

Sensitive but unclassified. Not for internet distribution.

1. (SBU) Summary: While not quite so pessimistic as they were two weeks ago about Turkey's immediate economic prospects, Istanbul financial analysts remain decidedly gloomy about the country's mid-term future. All agree that the Treasury seems to have next week's debt auction well in hand. In the mid-term, however, there is consensus that 30 percent real interest rates are not sustainable, and will shift for better or worse. Though an upside is "technically possible," in the words of former Disbank Chairman Vural Akisik, such an evolution would require government credibility in the markets, currently a sorely lacking commodity. Akisik and others stressed that at root (and counterintuitively) the problem is not fiscal. Turkey today enjoys the best economic fundamentals it has had in a decade. But without unstinting government commitment to half-heartedly accepted and long-delayed structural reforms, interest rates will not come down to a sustainable level. End Summary.

2. (SBU) Less short-term angst...: In a round of meetings during the week of March 31 with visiting Ankara DCM, Ankara Econ Counselor, and Istanbul Pol/Econ Chief, financial and real sector interlocutors indicated that their concerns had eased about the short-term sustainability of Turkey's debt. All agreed that the Treasury should be able to roll over the 4.8 quadrillion TL in treasury bills that come due on April 9. Analysts point to several factors: most importantly, the country's sentiment-driven markets, initially alarmed by a perceived breach in U.S.-Turkish relations at a time the country appeared increasingly isolated in Europe, have been calmed by Secretary Powell's visit and the proposed 1 billion USD assistance package. A range of technical factors also provide a safety margin to the Treasury: tax collections in March and April should provide some ready cash, while the state banks (little used in recent auctions) can step in as a last resort.

3. (SBU) ...but long-term gloom: Our interlocutors concurred, however, that in the medium to long-term it is hard to be hopeful. ING Barings Managing Director John McCarthy noted that given the current situation, one is "stretched for positive arguments" about Turkey's situation. With the economy at a standstill, the country is coming to a "dark time," he warned, and will have to seriously face up to the structural issues it has long ducked, or face a crisis along the lines of Mexico in the 1990s. Others were similarly pessimistic--Bender analysts Murat Gulkan and Emin Ozturk see "muddling through" as the best case scenario for Turkey, and can see no scenario for growth in the mid-term. Ozturk noted that there are few engines for growth this year (only exports seem poised for a positive performance, while consumption, public sector investment and tourism are all down), and a business decision to draw down inventories (which accounted for a large proportion of the growth in the fourth quarter of 2002) could cause the economy to contract.

4. (SBU) Positive fundamentals, but: Gulkan and Ozturk stressed that at root the problem is not fiscal, given that Turkey currently enjoys the best economic fundamentals it has seen in a decade. Continued strong performance on the fiscal side is a necessary but not sufficient condition for turning the economy around. Instead, they argued, the government must stop sending mixed signals to the markets and instead push the reform program wholeheartedly. Former Disbank Chairman Vural Akisik echoed this point, noting that Turkey's macro base is better than it has been since 1994. Because of

that, observers believe the government can get through the next months by "spending the ammunition" it has accumulated. But to achieve a sustainable real interest rate (which Akisik calculates at 35 percent), the government must have credibility with the markets, something that is now almost totally lacking. Reviewing the missed opportunities and missteps that have characterized the last few months, Akisik likened the situation to that of a husband who has cheated on his wife and now even when guiltless must pay attention to every nuance. In such a situation it is not enough that the government get the main issues right--the details must be perfect too.

15. (SBU) Captive audience: Many of our interlocutors concur that ultimately a restructuring of Turkey's domestic debt--either orderly or chaotic--is inevitable. They do not expect it soon, however. Most believe that the government can sustain the debt through 2003. Questions deepen for the following years, and one leading international bank has adjusted its baseline scenario to reflect a 2005 default as the most likely outcome. HSBC General Manager Antika concurs that restructuring is inevitable, but she (and the bank's Treasurer) do not see it happening this year. Indeed, she noted that HSBC's own interests militate against such a development, in that they mirror (though to a lesser degree) the predicament of the sector as a whole. With exposure to Turkish debt both on its balance sheet and in collateral for corporate loans, as HSBC's Treasurer told us, "we have an interest in keeping the boat afloat, not in profiteering from the situation." Other banks' situation is similar. Bender's Ozturk and Gulkan stressed (as they have repeatedly in recent months) that Turkish banks are captives of the system, and are essentially prevented from cashing out, since a decision by one bank to do so could bring the whole "house of cards" down.

16. (SBU) Restructuring: Intriguingly, however, we heard this week our first hint that the banks themselves may be receptive to some sort of controlled restructuring, in an effort to escape the treadmill on which they find themselves. Bank of New York Representative Neslihan Tombul told us on April 3 that she has heard that at least two banks (Isbank and Garanti) have sent feelers to the Treasury on the subject. Beyond the costs a restructuring might impose, depending on how it is formulated, she also sees benefits, in that with longer-term securities banks have a more stable balance sheet on which to operate.

17. (SBU) Comment: With reassurance on U.S.-Turkish ties helping to soothe Turkish markets in the short term, attention is again focused on the key imponderable of government credibility. We see little sign that the government will be able to recoup that commodity any time soon. Given its missteps, each government move has been closely scrutinized, and in many cases (as in the case of recent nominations to the board of Halkbank and Ziraat Bank) found wanting. Most Istanbul analysts remain decidedly downbeat on the government economic team, expressing grudging respect only for Finance Minister Unakitan. Only by reaching outside the government for a "Dervis," in Gulkan and Ozturk's view, can the government regain credibility. They (and we) see this as an extremely remote possibility, however. End Comment.
ARNETT